ANNUAL REPORT

SCIMITAR

AR60

HYDROCARBONS

CORPORATION

Winspear Business Reference Room
University of Alberta
1-18 Business Building
Edmonton, Alberta T6G 2R6

1997

FOR THE 12 MONTHS
ENDED JUNE 30, 1997

CORPORATE PROFILE

Scimitar is a Canadian-based international oil and gas exploration and production company that commenced operations in late 1995. The Scimitar name brings its connection to the previous successful companies of Scimitar's key principals, the Mackenzie family, who have been responsible for founding and operating companies valued at more than C$1 billion. Scimitar's current projects include exploration and development activities in Mozambique; Ajman, in the United Arab Emirates, and Egypt. Scimitar's common shares trade on The Alberta Stock Exchange under the symbol "SIY".

SCIMITAR'S STRATEGY

- Use Scimitar's unique international network to acquire large initial interests in highly prospective oil and gas projects.
- Target medium-size projects and areas that have not yet become industry hot spots in order to minimize expensive competition.
- Apply the best technology and cost reduction methods in ways not yet common for international projects - often techniques developed in Canada's highly competitive oil and gas industry.
- Bring in qualified co-venturers to cooperate in high capital investment programs and for long-term production operations once a project's potential has been demonstrated.
- Remain agile and cost-conscious by focusing on the front-end project development work Scimitar does best.

LIST OF ABBREVIATIONS

C$	Canadian Dollars
ENH	Empresa Nacional de Hidrocarbonetos de Mozambique, a Mozambican parastatal petroleum company
GPC	General Petroleum Company, S.A.E., an Egyptian parastatal petroleum company
MoU	Memorandum of Understanding
MMBO	Millions of barrels of oil
MMSCF/D	Millions of standard cubic feet per day of natural gas
OOIP	Original oil in place
PSA	Production Sharing Agreement
Scimitar	Scimitar Hydrocarbons Corporation, or wholly-owned subsidiary Scimitar Production International Ltd. or Scimitar Petroleum Developments Ltd.
TCF	Trillions of cubic feet of natural gas
US$	United States Dollars

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MESSAGE TO THE SHAREHOLDERS

Since Scimitar's first annual report a year ago, we have continued to apply our distinctive approach for creating shareholder value through projects in the international oil and gas industry.

The past year's achievements demonstrate the effectiveness of Scimitar's strategy. We have progressed each of our current projects toward proving oil and gas reserves and commencing production, and developed an asset portfolio covering a range of geographic areas, hydrocarbon types, risk profiles, and production timetables.

KEY EVENTS TO OCTOBER 20, 1997

- Memorandum of Understanding signed between Scimitar and Mozambican parastatal Empresa Nacional de Hidrocarbonetos de Mozambique (ENH), for the 4.2 million acre Inhaminga Block (October, 1996).
- Extensive 2-D seismic program completed over the 2.1 million acre Buzi-Divinhe Block, Mozambique (November, 1996).
- Memorandum of Understanding signed between Scimitar and Egyptian parastatal General Petroleum Company (GPC), for extensive engineering studies to lead to development of the 400 million barrel OOIP Issaran heavy oil field (December, 1996).
- Funding secured for current projects through placement of C$15.1 million Special Warrant offering (January, 1997).
- 70% of Scimitar's Ajman, UAE, concession farmed out (March, 1997).
- Agreement with major South African mining house JCI Limited, for an option covering sale of up to 1.2 TCF of natural gas from the Buzi-Divinhe Block to a proposed iron project in the Beira Free Trade Zone (June, 1997). Scimitar receives US$300,000 for granting this option.

1997 PROJECT AREAS

- Expansion of Buzi-Divinhe Block, Mozambique, to 3.1 million acres, based on results of 1996 seismic program (July, 1997).
- Commencement of a two-well exploration drilling program in the Buzi-Divinhe Block, Mozambique (August, 1997).
- Acquisition of offshore 3-D seismic data in Ajman, UAE, concession (September, 1997). Scimitar is carried at no cost.
- Bandua-1, the first of Scimitar's two 1997 Mozambique exploration wells, is plugged and abandoned after encountering non-commercial shows of natural gas in the target zones. Scimitar immediately commences drilling of the second well, Garabega-1 (October, 1997).
- Heads of Agreement for the Issaran heavy oil project in Egypt negotiated and awaiting approval (October, 1997), defining key financial and other terms for proceeding with the project.

SCIMITAR'S STRATEGY

We believe that Scimitar's combination of strategy elements is unique — and uniquely capable of generating superior shareholder value.

Scimitar's *international network* is a significant advantage in the early identification and acquisition of highly prospective projects — before costs are driven up by increased competition. Scimitar's Board members and executives include long-time residents of the Middle East, whose track records of success in the region are a basis for access to important future business opportunities. Scimitar's Egyptian heavy oil project and the Ajman, UAE, concession provide examples of this network's capabilities.

Scimitar controls its costs by *targeting mid-size projects* with potential for sizable impact, but which are not primary targets for large international competitors. As well, Scimitar will selectively enter countries that are currently *not industry "hot spots."* Scimitar's early move into Mozambique exemplifies this strategy element.

Scimitar applies the *best technology and cost-reduction methods* to manage risk, in ways that are often not yet common internationally. Frequently, these methods will have been developed in the very competitive western Canadian oil and gas industry, as can be seen with Scimitar's applications of seismic methods in Mozambique and planned implementation of heavy oil production techniques in Egypt. This factor and the availability of top-notch technical personnel are benefits of Scimitar's base in Canada. Scimitar targets areas with established potential, generally for field exploitation projects or exploration in the vicinity of existing hydrocarbons.

After initial work has demonstrated the potential of its projects, Scimitar will normally *bring in established operating oil companies to conduct long-term field operations and to participate in the larger capital investments.* Suitable technologically focused and cost-focused mid-size firms now operate internationally. Scimitar will generally remain a significant, non-operating partner after this point in the project cycle. Scimitar has brought its Ajman, UAE, project to this point with the 1997 participation agreement.

By keeping its *focus on the front-end* project development work it does best, Scimitar will be able to remain cost-conscious, lean, and agile, while at the same time building reserves and production.

Though we believe the fundamentals of Scimitar's strategy will remain effective for some time to come, we also expect to deliberately adjust the details to suit specific projects and to evolve the overall strategy in step with changing industry conditions. Scimitar will build on this foundation to carry its current projects forward, as well as to develop the additional projects which we plan to confirm and proceed with over the next year.

INDUSTRY CONDITIONS AND OUTLOOK

Conditions in the international petroleum industry continue to be ideal for Scimitar.

Energy prices have remained generally buoyant into late 1997, leading to increased industry activity levels — and oilfield service sector costs — worldwide. This environment reinforces Scimitar's attention to the low cost structure that will enable our projects to maintain desirable profit margins. One recent example is Scimitar's contract for drilling of its 1997 Mozambique exploration wells, under which a local mining rig was converted to oil and gas drilling service to achieve immediate program cost savings and also to create increased local

competition for future years. Furthermore, certain of Scimitar's projects are held under production sharing agreements that allow Scimitar to recover its capital and operating costs before profit sharing with host governments. This agreement structure accelerates investment paybacks and provides a useful downside hedge in the event of future narrower netbacks due to cost increases or price fluctuations.

While project development internationally can at times take longer than in North America, the level of competition for high-impact project opportunities remains lower in those international areas which Scimitar has selected. This provides Scimitar with the ability to better control its project acquisition costs — and to maximize its future profit margins. Consequently, Scimitar's main focus will continue to be on projects outside North America, though North American prospects could be considered if they meet our selection criteria.

Further commercialization of medium-scale natural gas-to-diesel fuel processes occurred during 1997. This development indicates an opportunity for development of mid-size natural gas projects in areas currently remote from markets, which to date have often been uneconomic due to lack of sufficient scale to support long-distance pipelines or liquefied natural gas plants. Coupled with burgeoning worldwide natural gas demand and other positive technological developments, this trend reinforces Scimitar's plan to evaluate selected international natural gas projects.

Within this next year, Scimitar intends to establish its first proved reserves and production volumes. Production growth in subsequent years is expected to be rapid, as additional projects move from the early development to the full production stage, and further new projects are acquired. We remain on target for Scimitar to become a significant junior player in the international oil and gas industry by the year 2000.

SCIMITAR'S ORGANIZATION

Scimitar augmented its Board of Directors, through the election in December, 1996, of Wasfi A. Ataya, Paul G. Hotchkiss, Conrad P. Kathol, P.Eng., and Charles E. Parnell. In combination with continuing Board members Gerald A. Mackenzie (Chairman), Angus A. Mackenzie, Mark R. Smith (Managing Director), and Robert C. Stewart, Scimitar's Board provides seasoned business counsel across the full range of the upstream petroleum industry and corporate governance activities.

Scimitar also strengthened its operational organization, with the following appointments: Mark R. Smith as Chief Executive Officer in addition to his previous role as Managing Director, Gordon D. Holden, P.Eng. as Chief Operating Officer in addition to his previous role as Director, Projects, Donald H. Smith, P.Eng. as Petroleum Engineering Advisor, and Janice L. Brunton as Controller. These organizational changes will serve as a solid platform for Scimitar's next year. Scimitar is also proceeding with further additions to its technical staff, to ensure sufficient internal resources for our increasing scope of operations.

ACKNOWLEDGMENTS

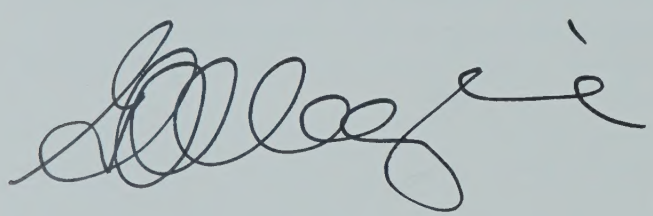
Scimitar achieved important operational milestones during the past year, and the proving of significant reserves and commencement of production are now within sight. This is quite an achievement for a new international company created from a standing start only two years ago and which has not purchased existing production.

While there has been considerable success operationally, Scimitar's share price performance has recently been unsatisfactory. Your Board and Management fully commit themselves to remedying this situation within the next year.

Though our shareholder value objectives are not yet fulfilled, it is nevertheless appropriate for me to acknowledge the exceptional contributions of Scimitar's employees, key contractors, management, and Board members, and to express my appreciation for the continued support of our shareholders.

I also wish to recognize the efforts of Grant H. Grimsrud (formerly President) and Bill G. Calsbeck (formerly Director, Investor Relations), who were instrumental in the formation of Scimitar and are now pursuing their varied other interests.

Submitted on behalf of the Board of Directors:



Gerald A. Mackenzie,
Chairman of the Board

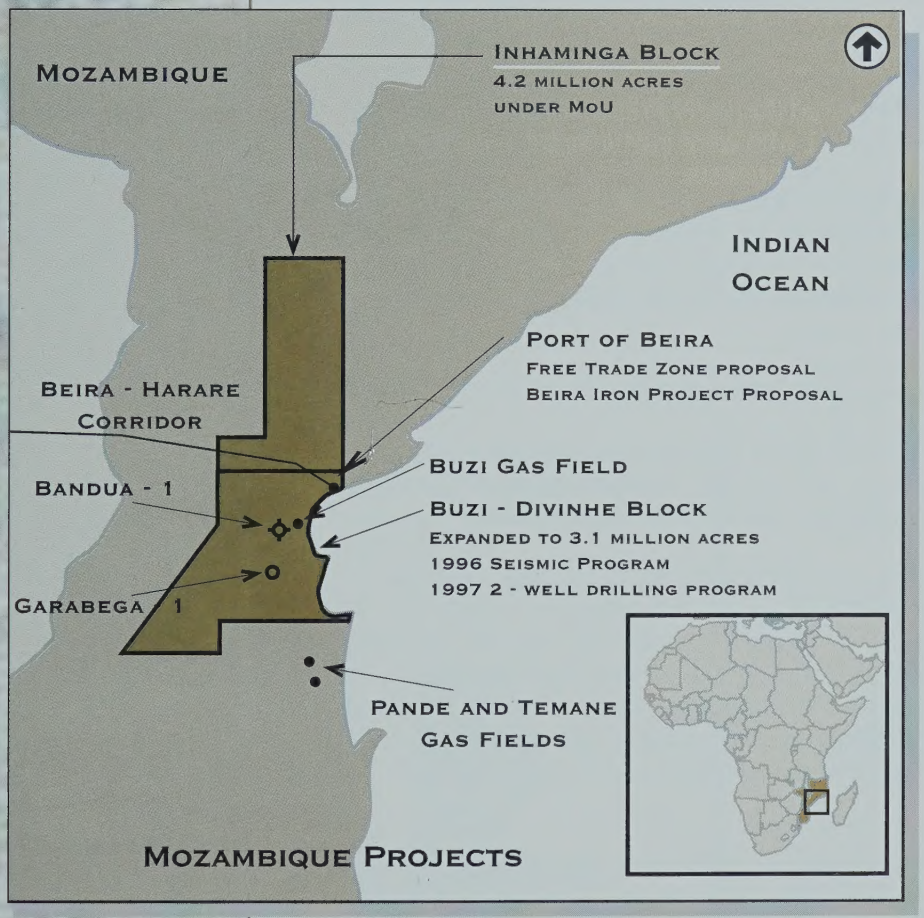
October 20, 1997

REVIEW OF OPERATIONS

BUZI-DIVINHE BLOCK AND INHAMINGA BLOCK, MOZAMBIQUE

Scimitar entered the Mozambique sedimentary basin in 1995, through signing a Production Sharing Agreement for the 2.1 million acre Buzi-Divinhe Block. Exploration and development in Mozambique offer Scimitar the potential for very large natural gas and condensate reserves which could be put into production in year 2000 and later.

There have been very positive developments over this past year, which indicate an encouraging future for Mozambican hydrocarbon exploration and development:



- The Mozambican business environment has continued to achieve notable gains. Economic growth is strong and the international investment community is taking increasing notice of this political and economic success story, as illustrated by recent favourable coverage in The Times (London), The Economist, Time Magazine, The Globe and Mail, and others.
- Several large gas-consuming industrial projects have been further developed toward the full go-ahead stage. Among these projects is the Beira Iron Project, to be located near the port of Beira within Scimitar's Buzi-Divinhe Block. Major South African mining house JCI Limited is the leading proponent of this iron ore conversion project, which would be designed to utilize over 100 MMSCF/D of natural gas for 30 years. In mid-1997, Scimitar and its co-venturer granted to JCI an option to purchase 1.2 TCF of natural gas from the Buzi-Divinhe Block. Scimitar received US$300,000 for granting its portion of this option.
- A Beira Free Trade Zone proposal is being progressed, with the objective of attracting additional industries to the Beira area. Such industries would utilize natural gas as an energy source or feedstock.
- The Beira Corridor, which includes rail, highway, and pipeline links from Beira to Harare, Zimbabwe, is becoming a focal point for additional upgrading and development.
- Enron's project for pipelining Pande gas field reserves south to Maputo, and possibly the Republic of South Africa, continues to make progress.

This environment has resulted in most oil and gas rights in the Mozambican sedimentary basin being acquired by various international operators, including major companies such as Arco, BP, Enron, and Sasol.

1996 BUZI-DIVINHE BLOCK SEISMIC PROGRAM

Scimitar's first field work in the Buzi-Divinhe Block was the seismic program conducted during the 1996 dry season (usually June through November). The 1996 seismic program focused on developing drillable locations for the 1997 dry season, so that gas market development work could be advanced as early as possible.

Over 300 kilometres of high-quality seismic data were obtained, covering leads developed from the extensive 1960s-vintage seismic and well database. The program was carried out at a substantial cost saving, due to "on-the-fly" changes made to its design while the seismic data was being acquired in the field. This approach was made possible by the use of in-field computer processing using sophisticated interpretation diagnostics, and regular satellite transmission of the processed data back to Calgary for interpretation.

Two firm drilling locations were finalized on the basis of final interpretations from the 1996 seismic program. A large number of follow-up locations were also determined, but before being firmed up, these will require additional seismic data acquisition and assessment of results from the initial drilling.

The 1996 seismic data provided information indicating that the prospective hydrocarbon fairway in the region extended beyond the boundaries of the Buzi-Divinhe Block, onto unallocated lands. On this basis, Scimitar applied for and was granted an extension adding approximately 900,000 acres to the south west, bringing the Block's total area to approximately 3.1 million acres.

1997 BUZI-DIVINHE BLOCK DRILLING PROGRAM

The 1997 drilling locations were selected to test two of the five different geological areas of the Buzi-Divinhe Block. The first location, Bandua-1, was a test of medium-depth prospects in the northern area of the Block immediately around the existing small Buzi gas field.

Bandua-1 was drilled to a total depth of 1,900 metres (approximately 6,234 feet). Scimitar contracted a South African mining rig converted to oil and gas drilling service in order to achieve immediate program cost savings and also to create increased local supplier competition for future years. On October 10, 1997, Bandua-1 was plugged and abandoned after encountering small gas shows in the two seismically defined target zones. Although Bandua-1 did not discover commercial gas reserves, several key modern wireline logs were acquired at Bandua-1 which will allow adjustments to be made to future exploration in the immediate vicinity and in the balance of the Block.

The second well of the 1997 drilling program was spudded on October 20, 1997, with a prognosed total depth of 2,050 metres (approximately 6,725 feet). This well, Garabega-1, will test a central portion of the Block where geological faulting is less intense than near Bandua-1 and consequently the potential discovery size could be much greater.

After completion of its two 1997 wells, Scimitar will hold a 75% interest in the Buzi-Divinhe Block and will have satisfied PSA minimum work commitments to early in the year 2000. Future drilling is expected to focus on following up on any discoveries and on testing the other prospective areas of the Block. Deeper zones in the area have also been shown by 1960s drilling to have promising potential.

INHAMINGA BLOCK

By way of a Memorandum of Understanding signed in October, 1996, Scimitar holds a 100% interest in the 4.2 million acre Inhaminga Block which borders the northern edge of the Buzi-Divinhe Block.

Inhaminga Block, Mozambique (Continued)

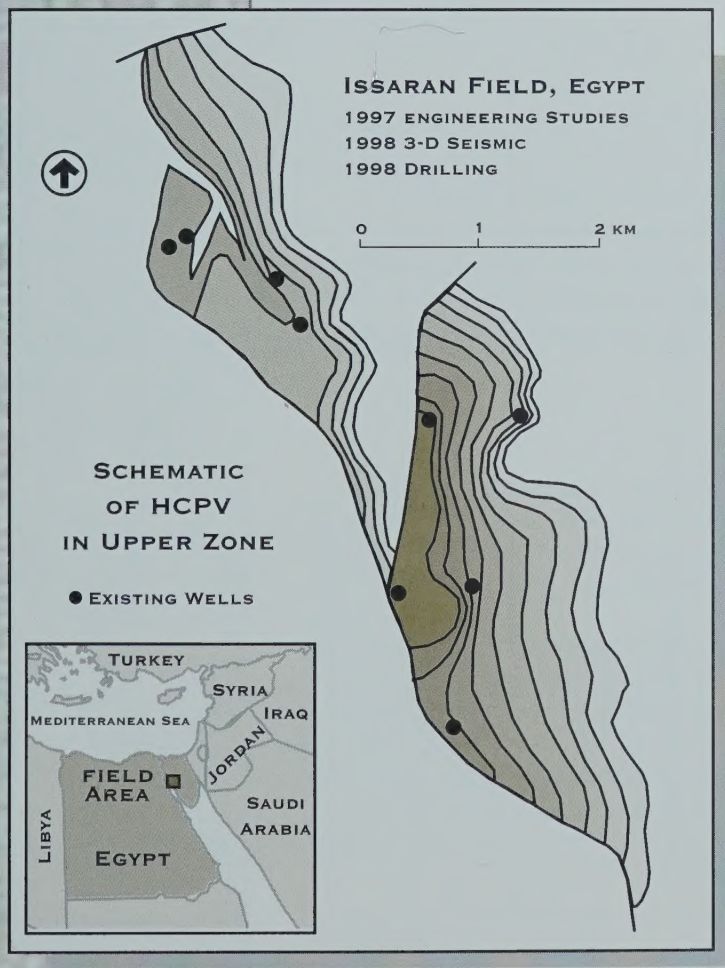
After analysis of results from 1997 operations in Mozambique, Scimitar will decide whether to convert the Inhaminga MoU to a Production Sharing Agreement. Key terms for an Inhaminga PSA have already been pre-negotiated.

Issaran Heavy Oil Project, Egypt

In December, 1996, Scimitar signed a Memorandum of Understanding (MoU) with the Egyptian parastatal General Petroleum Company (GPC), for engineering studies to lead to development of the Issaran heavy oil field. Issaran, located in the established onshore Gulf of Suez oil region, was discovered in the 1980s by companies exploring for light oil in deeper zones and has not been substantially developed.

Under its MoU, Scimitar has conducted extensive studies of the potential for exploitation of the over 400 million barrels of oil in place at Issaran. These studies by independent heavy oil production specialists concluded that Issaran heavy oil development can be profitable utilizing primary and possibly thermal production methods. Canadian-developed gravity drainage steam processes appear to have considerable promise for application in this shallow, very high-quality carbonate reservoir, though there is not yet a track record of such applications.

Scimitar currently holds 90% of the Issaran project, and a farmout option agreement exists that could reduce Scimitar's holding to 80%. Given the Issaran project's stage of development, it is likely that Scimitar will within the next year take on an additional co-venturer to cooperate in planned field development programs.



Issaran Development Plan

Issaran development would commence with detailed assessment of the field's existing wells and local infrastructure, followed by acquisition of a field-wide 3-D seismic program to determine optimal locations for new development wells. Drilling and first production would take place during 1998.

Full delineation of the field would be planned for years 1998 through 2000 in combination with detailed design and pilot testing of thermal methods. Successful thermal piloting would lead to staged expansions of thermal production to suitable parts of the field in years after 2000. A commercial development would be targeted to produce long-life reserves over a span of 30 years or more.

The area around Issaran is a well-established producing region with existing gas, oil, and water pipelines, and facilities for heavy oil exports to world markets. Numerous opportunities exist for Scimitar to increase its scope of operations in the region using Issaran as a base.

HEADS OF AGREEMENT

During mid-1997, Scimitar presented the results of its studies to GPC and has since negotiated the key terms of an agreement suitable for proceeding with Issaran development. We plan to proceed aggressively with the initial field work for this project upon receiving approvals of these Heads of Agreement.

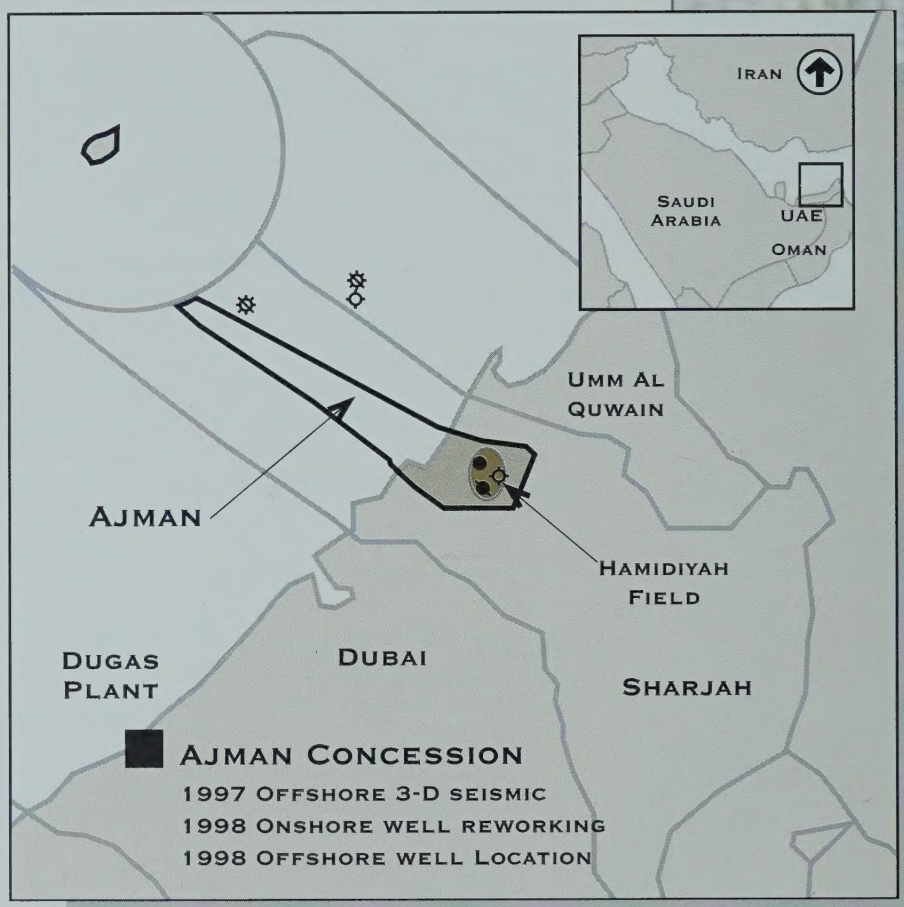
AJMAN CONCESSION, UNITED ARAB EMIRATES

During the first half of 1997, Scimitar farmed out 70% of its Ajman Concession in the United Arab Emirates. This is the first of Scimitar's projects to be converted to the non-operated stage.

OFFSHORE 3-D SEISMIC PROGRAM

Scimitar's co-venturer is the operating subsidiary of a significant offshore seismic company. After renegotiation of the Concession Agreement with the Government of Ajman, over 260 square kilometres of 3-D ocean bottom cable seismic data were acquired during September, 1997. As part of the joint venture arrangement, this work was carried out at no cost to Scimitar's 30% interest.

Processing of the seismic data is currently in progress. Interpreted results are expected to be available in late 1997 or early 1998.



1998 AJMAN DRILLING PLANS

An offshore exploration well would be drilled during 1998 if a suitable location is determined on the basis of the new seismic data. Based on discovery wells in offsetting areas, such an offshore exploration well would have potential for oil, natural gas, or condensate. A well-developed local infrastructure is in place for the handling and marketing of any production.

Also during 1998, Scimitar and its co-venturer plan to conduct reworking operations on one of the existing onshore wells within the Ajman Concession. While there is currently production of 20 barrels of condensate per day, these revenues are being retained by the Emirate.

Scimitar and its co-venturer have established an Area of Mutual Interest (AMI) for areas around the Ajman Concession, under which Scimitar has the right to participate at a 30% interest in other projects as may be acquired.

OTHER PROJECTS

Scimitar is continually evaluating new projects and assessing them against our selection criteria. We are continuing to develop several projects to expand on our current project base.

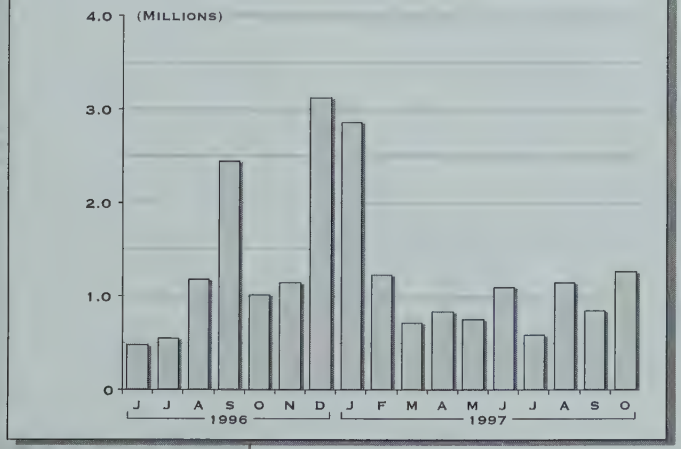
Submitted on behalf of the Executive Committee:

Mark R. Smith
Managing Director &
Chief Executive Officer

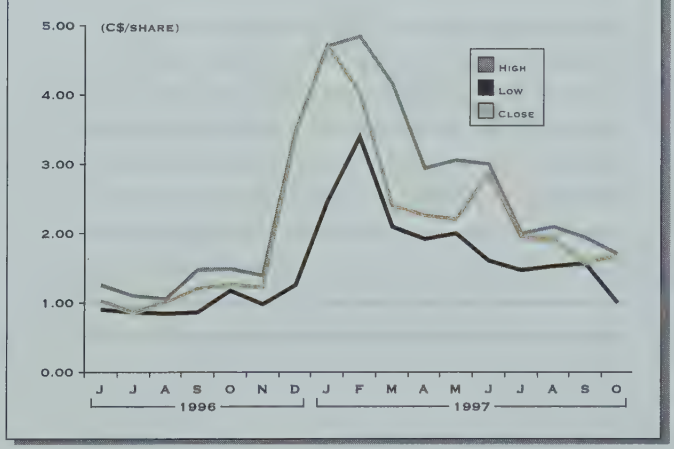
Calgary, Canada
October 20, 1997

SHARE PRICE PERFORMANCE

STOCK TRADING VOLUME SUMMARY
(VOLUMES FOR JUNE 1, 1996 - OCTOBER 10, 1997)



STOCK PRICE SUMMARY
(HIGH-LOW-CLOSE FOR JUNE 1, 1996 - OCTOBER 10, 1997)



MANAGEMENT'S REPORT TO THE SHAREHOLDERS

The financial statements of Scimitar Hydrocarbons Corporation were prepared by Management in accordance with accounting principles generally accepted in Canada, and are consistent with the financial and operating information presented in this Annual Report.

Management maintains a system of internal controls to provide suitable assurance that all assets are safeguarded and to enable preparation of reliable and timely financial statements for reporting purposes. Timely disclosure may require the use of estimates, in cases where transactions affecting the current reporting period cannot be finalized or known for certain until future periods. Such estimates are based on judgements made by Management, using all relevant information known at the time.

External auditors appointed by the shareholders have examined the corporate and accounting records in order to express their opinion on the financial statements. The Audit Committee has met with the external auditors and Management to determine if Management has fulfilled its responsibilities in the preparation of these financial statements. The Audit Committee has reported its findings to the Board of Directors who have approved the financial statements.

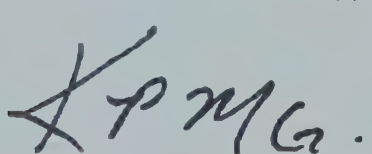
Mark R. Smith
Managing Director & Chief Executive Officer

AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheets of Scimitar Hydrocarbons Corporation as at June 30, 1997 and 1996 and the consolidated statements of operations, deficit and changes in financial position for the years then ended. These financial statements are the responsibility of the corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the corporation as at June 30, 1997 and 1996 and the results of its operations and the changes in its financial position for the years then ended in accordance with generally accepted accounting principles.



Chartered Accountants
Calgary, Canada. August 15, 1997

CONSOLIDATED BALANCE SHEETS

June 30, 1997 and 1996
(Expressed in Canadian Dollars)

	1997	1996
ASSETS		
Current assets:		
Cash and short term deposits	$ 13,987,030	$ 207,504
Accounts receivable	482,880	58,214
Prepaid expenses	4,988	6,000
Marketable securities	–	156,768
	14,474,898	428,486
Capital assets (note 4)	8,356,306	4,263,994
Goodwill, net of amortization	88,800	155,500
	$ 22,920,004	$ 4,847,980
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	$ 857,715	$ 454,481
Shareholders' equity:		
Share capital (note 5)	22,699,897	4,708,244
Deficit	(637,608)	(314,745)
	22,062,289	4,393,499
Basis of presentation (note 1)		
Commitments (note 7)		
	$ 22,920,004	$ 4,847,980

See accompanying notes to consolidated financial statements.

Approved by the Board:

Director

Director

CONSOLIDATED STATEMENTS OF OPERATIONS

Years ended June 30, 1997 and 1996
(Expressed in Canadian Dollars)

	1997	1996
Corporate items:		
Corporate expenditures	$ 640,948	$ 188,021
Amortization of goodwill	66,700	44,500
Write-down of marketable securities	–	71,000
Depreciation of furniture and equipment	29,529	11,224
	737,177	314,745
Less other items:		
Interest income	280,138	–
Foreign exchange gain	134,176	–
Net loss	$ 322,863	$ 314,745
Loss per share	$ 0.02	$ 0.03

CONSOLIDATED STATEMENTS OF DEFICIT

Years ended June 30, 1997 and 1996
(Expressed in Canadian Dollars)

	1997	1996
Deficit, beginning of year	$ (314,745)	$ –
Net loss	(322,863)	(314,745)
Deficit, end of year	$ (637,608)	$ (314,745)

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION

Years ended June 30, 1997 and 1996
(Expressed in Canadian Dollars)

	1997	1996
Cash provided by (used in):		
Operations:		
Net loss	$ (322,863)	$ (314,745)
Depreciation and amortization	96,229	55,724
Write-down of marketable securities	–	71,000
	(226,634)	(188,021)
Investing:		
Additions to capital assets	(4,121,841)	(1,691,425)
Change in non-cash working capital	136,348	(36,197)
	(3,985,493)	(1,727,622)
Financing:		
Issue of common shares, net of share issue costs	17,991,653	2,621,854
Repayment of note payable	–	(298,947)
Goodwill	–	(200,000)
	17,991,653	2,122,907
Increase in cash and short-term deposits	13,779,526	207,264
Cash, beginning of year	207,504	240
Cash and short-term deposits, end of year	$ 13,987,030	$ 207,504

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended June 30, 1997 and 1996
(Expressed in Canadian Dollars)

INCORPORATION:

Scimitar Production International Ltd. ("SPIL") was incorporated on March 15, 1995 in the British Virgin Islands. On November 10, 1995, SPIL was acquired by Commonwealth Energy Inc., a corporation incorporated under the *Alberta Business Corporations Act*. This acquisition was accounted for as a reverse take-over and the name of the combined companies was changed to Scimitar Hydrocarbons Corporation (the "Corporation") on January 2, 1996 (see note 3).

1. BASIS OF PRESENTATION:

These consolidated financial statements are expressed in Canadian dollars and are prepared in accordance with accounting principles generally accepted in Canada.

These consolidated financial statements include the accounts of the Corporation and those of its wholly-owned subsidiary.

The Corporation's activities to date have been directed toward the exploration for and development of international petroleum and natural gas properties. The Corporation has acquired interests in undeveloped petroleum and natural gas properties in Mozambique and United Arab Emirates. Planned principal operations have not commenced in either location and are considered by management to be in the preproduction stage. As a result all costs associated with such activities, net of revenues, have been capitalized as exploration costs as a component of capital assets (note 4). Those costs associated with general corporate overhead are expensed in the period in which they are incurred.

The ultimate recovery of the Corporation's investment is dependent upon the discovery of petroleum and natural gas reserves in commercial quantities, the completion and maintenance of the necessary agreements with the applicable regulatory authorities, and the availability of necessary financing to complete the exploration and development of its holdings.

2. SIGNIFICANT ACCOUNTING POLICIES:

(a) Capital assets:

The Corporation follows the full cost method of accounting for petroleum and natural gas operations whereby all costs of exploring for and developing petroleum and natural gas properties and related reserves are capitalized into a cost centre for each country in which the Corporation has operations. Such costs include land acquisition costs, costs of drilling both productive and non-productive wells, geological and geophysical expenses and well equipment.

SIGNIFICANT ACCOUNTING POLICIES (CONTINUED):

(a) Capital assets (continued):

Upon achieving commercial production, capitalized costs will be depleted using the unit-of-production method based on estimated proved reserves of petroleum and natural gas before royalties as determined by an independent engineer. For purposes of the depletion calculation, natural gas reserves and production are converted to equivalent volumes of crude petroleum based on the approximate relative energy content.

Gains or losses on the sale or disposition of petroleum and natural gas properties are not ordinarily recognized except under circumstances which result in a major revision of depletion rates.

The Corporation will annually apply a "ceiling test" to capitalized costs to ensure that such costs do not exceed future net revenues from estimated production of proven reserves, using prices and costs in effect at the Corporation's year end. Future net revenues are calculated after deducting general and administrative costs, financing costs, income taxes and future site restoration and abandonment costs.

Estimated future site restoration and abandonment costs, net of expected recoveries, are provided over the life of the proved reserves using the unit-of-production method. Costs are estimated each year by management based on current regulations, costs, technology and industry standards. The annual charge is included in depletion and actual removal and site restoration expenditures are charged to the accumulated provision account as incurred.

Certain of the Corporation's exploration and production activities are conducted jointly with others and, accordingly, the accounts reflect only the Corporation's proportionate interest in such activities.

Depreciation of furniture and equipment is based on estimated useful life and is calculated using the declining balance method at rates of 20% to 40%.

(b) Goodwill:

Goodwill costs, representing the excess of the purchase price over the fair values of net assets acquired, are amortized using the straight-line method over a three year period from the acquisition date. The value of goodwill is periodically evaluated by management and where there is considered to be an impairment in the estimated net recoverable amount of the goodwill, it is written down to its estimated value.

(c) Marketable securities:

Marketable securities are recorded at the lower of cost and market at the balance sheet date.

(d) Foreign currency translation:

Monetary assets and liabilities are translated at the rates of exchange at the balance sheet dates. Non-monetary assets and liabilities are translated at the rates in effect at the dates the assets or liabilities were acquired. Revenues and expenses are translated at the average rates of exchange during the month in which they are recognized. The resulting gains or losses are included in earnings, except that foreign exchange gains or losses arising on translation of long-term monetary assets and liabilities are deferred and amortized over their remaining term.

(e) Loss per share:

The loss per share is calculated using the weighted average number of shares outstanding during the period.

3. BUSINESS COMBINATION:

On November 10, 1995, the shareholder of SPIL entered into an agreement with Commonwealth Energy Inc. ("Commonwealth") whereby the shareholder agreed to sell 100% of its shares in exchange for 5,000,000 common shares of Commonwealth (note 5). The consolidated financial statements have been prepared on the basis that control of the combined companies passed to the shareholder of SPIL. This form of business combination is referred to as a "reverse takeover" and SPIL is regarded as the acquirer of Commonwealth. Accordingly, control of the assets and business of Commonwealth are acquired in consideration for the issuance of shares of SPIL.

The acquisition has been accounted for using the purchase method whereby the consolidated financial statements reflect the assets, liabilities and shareholders equity of SPIL at historic amounts and the assets and liabilities of Commonwealth at fair values as follows:

Cash	$ 177,222
Goodwill	200,000
Consideration - common shares	$ 377,222

4. CAPITAL ASSETS:

	1997	1996
Undeveloped petroleum and natural gas properties:		
United Arab Emirates	$ 3,453,466	$ 2,860,431
Mozambique	3,753,342	1,323,481
Egypt	594,817	-
Other	470,260	55,005
Furniture and equipment, (net of accumulated depreciation of $40,753 (1996 - $11,224))	84,421	25,077
	$ 8,356,306	$ 4,263,994

During the year ended June 30, 1997, the Corporation capitalized $1,393,740 (1996 - $636,995) of administrative overhead costs related to the exploration for petroleum and natural gas properties.

5. SHARE CAPITAL:

(a) Authorized:

Unlimited number of common shares

50,000,000 non-voting preferred shares

(b) Issued:

	Number of Shares	Amount
Balance, June 30, 1995	10,000	$ 2,086,390
Common share capital of Commonwealth at time of acquisition	3,614,274	–
Issued on acquisition of SPIL	5,000,000	377,222
Issued through private placements for cash	2,328,230	1,164,115
Issued through private placements for shares	630,000	396,900
Stock options exercised for cash	201,706	45,141
Issued in lieu of salary	16,307	12,556
Issued on exercise of warrants	883,793	662,845
Share issue costs	–	(36,925)
Balance, June 30, 1996	12,674,310	4,708,244
Issued on exercise of warrants	584,480	650,600
Issued on exercise of stock options	561,667	346,967
Issued through private placement for cash	3,547,322	3,015,224
Issued in exchange for special warrants	5,500,000	15,125,000
Issued in lieu of salary	78,236	70,000
Share issue costs	–	(1,216,136)
Balance, June 30, 1997	22,946,015	$ 22,699,897

SHARE CAPITAL (CONTINUED):

(c) Stock options:

The Corporation has a stock option plan under which the Board of Directors may grant stock options to directors, officers, employees and key consultants for the purchase of common shares.

Number of Options	Price	Expiry Date
410,000	$0.44	November 10, 2000
150,000	0.65	July 4, 2001
100,000	0.85	July 4, 2001
125,000	1.00	July 4, 2001
15,000	1.00	November 29, 2001
90,000	1.15	December 2, 2001
19,333	1.09	November 29, 2001
100,000	1.00	November 29, 2001
250,000	1.09	November 29, 2001
410,000	2.20	April 15, 2002
3,000	2.25	April 15, 2002
1,672,333		

(d) Warrants issued and outstanding:

	Warrants	Exercisable to Common Shares	Price	Expiry Date
Balance, June 30, 1995	–	–	$ –	
Issued through private placement	300,000	300,000	0.75	April 30, 1996
Issued through private placement	2,758,230	2,758,230	0.75	May 10, 1996
			1.25	November 10, 1996
Exercised for cash	(883,793)	(883,793)	0.75	
Balance, June 30, 1996	2,174,437	2,174,437		
Exercised for cash	(584,480)	(584,480)		
Issued through private placement	3,547,322	3,547,322	1.25	March 30, 1998
Issued through special warrants	3,000,000	3,000,000	3.50	October 28, 1997
			6.00	January 28, 1998
Expired November 10, 1996	(1,739,957)	(1,739,957)		
Balance, June 30, 1997	6,397,322	6,397,322		

6. INCOME TAXES:

The provision for income taxes differs from the amount obtained by applying the combined Federal and Provincial income tax rates to income before income taxes. The difference relates to the following items:

	1997	1996
Loss before income taxes	$ 322,863	$ 314,745
Corporate tax rate	44.6%	44.6%
Expected income tax recovery	(144,000)	(140,376)
Unrecognized benefit of losses	144,000	140,376
	$ –	$ –

At June 30, 1997, the Corporation had non-capital losses of approximately $752,000 (1996 - $625,000) and net capital losses of approximately $68,000 (1996 - $11,000) available to reduce future income taxes. The benefit of these losses has not been reflected in these financial statements.

7. COMMITMENTS:

Pursuant to a concession agreement dated March 20, 1997 for the Ajman, U.A.E. concession, the Corporation and its partner have a commitment to spend US$4,000,000 in the initial 18 months. Although the Corporation has a working interest of 30%, it is being carried (at no cost) through an offshore seismic program with a value of at least US$3,000,000. Should the concession be extended into a second term, the commitment by all the partners is to spend an additional US$15,000,000, with the Corporation's share thereof being US$4,500,000.

With respect to the production sharing agreement, dated December 15, 1995 for the Buzi-Divinhe Block, Mozambique, and the terms of the farm-in agreement dated April 22, 1995, the Corporation, in the first 21 month phase, was required to spend US$1,000,000, on a seismic program which was completed in late 1996. In the second 12 month extension phase, the Corporation is required to spend US$1,000,000 on the drilling of one well. In a further 18 month extension phase, which may be entered into at the Corporation's option, the Corporation is required to spend US$1,000,000 on drilling a second well.

8. FINANCIAL INSTRUMENTS:

The Corporation's financial instruments recognized in the balance sheet consist of accounts receivable and accounts payable and accrued liabilities. The fair values of the financial instruments recognized in the balance sheet approximate their carrying amounts due to the short-term maturity of these instruments.

9. SEGMENTED INFORMATION:

(a) In 1997, the Corporation continued the majority of its exploration activities in Mozambique and the United Arab Emirates. The accounting policies are consistent for all segments.

June 30, 1997	United Arab Emirates	Mozambique	Egypt	Other	Total
Corporate expenses, net					$ 322,863
Net loss					$ 322,863
Identifiable assets	$ 3,453,466	$ 3,753,342	$ 594,817	$ 554,681	$ 8,356,306
Corporate assets					14,563,698
Total assets					$22,920,004

(b) June 30, 1996	United Arab Emirates	Mozambique	Other	Total
Corporate expenses, net				$ 314,745
Net loss				$ 314,745
Identifiable assets	$ 2,860,431	$ 1,323,481	$ 80,082	$ 4,263,994
Corporate assets				583,986
Total assets				$ 4,847,980

BOARD OF DIRECTORS

Wasfi A. Ataya, B.S., M.Eng. (Dubai, U.A.E.)

Paul G. Hotchkiss, B.Ed. (Calgary, Canada)

Conrad P. Kathol, P.Eng. (Calgary, Canada)

Angus A. Mackenzie* (Montego Bay, Jamaica)

Gerald A. Mackenzie (Ajman, United Arab Emirates)

Charles E. Parnell (London, UK)

Mark R. Smith*, B.Comm., LL.B. (Calgary, Canada)

Robert C. Stewart* (Calgary, Canada)

**Audit Committee member*

EXECUTIVE OFFICERS AND KEY MANAGEMENT

Mark R. Smith, B.Comm., LL.B. (Calgary, Canada)
- Managing Director, Chief Executive Officer and Secretary to the Board of Directors
- Partner, Osler, Hoskin & Harcourt (Barristers & Solicitors)

John L. Dragonetti, B.A., M.A. (Dubai, United Arab Emirates)
- Director, Operations
- President, Scimitar Production International Ltd.

Gordon D. Holden, P.Eng., M.Sc. [Dist.] (Calgary, Canada)
- Director, Projects and Chief Operating Officer

Janice L. Brunton (Calgary, Canada)
- Controller

Niheriwa Maseliha, B.Sc., M.Sc. (Maputo, Mozambique)
- Assistant General Manager, Mozambique

SOLICITORS

Osler, Hoskin & Harcourt
Calgary, Canada

BANKERS

Royal Bank of Canada
Calgary, Canada

The Hongkong Bank of Canada
Calgary, Canada

AUDITORS

KPMG

REGISTRAR & TRANSFER AGENT

CIBC Mellon Trust Company

ANNUAL MEETING

Thursday, December 4, 1997 at 10:00 a.m.
The Westin Hotel (Mayfair Room), 320 - 4th Avenue, S.W., Calgary, Alberta

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SCIMITAR HYDROCARBONS CORPORATION

300 Canada Place, 407 Second Street, S.W.
Calgary, Alberta, CANADA, T2P 2Y3
Telephone: +1 403 543-0333 Fax: +1 403 543-0344
E-mail: info@scimitar.ab.ca
Website: http://www.scimitar.ab.ca

SCIMITAR PRODUCTION INTERNATIONAL LTD.
Maputo, Mozambique
Telephone: +2581 429-302 Fax: +2581 429-380

SCIMITAR PRODUCTION INTERNATIONAL LTD.
Dubai, United Arab Emirates
Telephone: +971 4-480315 Fax: +971 4-487709

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The Alberta Stock Exchange
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